(because PEG channels appear on the BST).[263] We believe that in most cases, non-PEG franchise related costs should be assigned directly to the tier associated with the costs. Therefore, the only external costs which cannot generally be directly assigned are franchise fees and cable specific taxes. Our rules require that franchise fees be assigned in accordance with the method most consistent with the method of assessment of the fees by local franchising authorities.[264] Usually this involves a percentage of tier fees, therefore corresponding tier assignment would involve a reasonable cost causative linkage in accordance with GAAP. Also in accordance with GAAP, certain cable specific taxes should likewise be assigned using the method of assessment most consistent with the assessment method of the cable specific tax.

123. While we agree with Continental's general recommendation that the Commission should continue to take a flexible approach to cost allocation based on our *Cost Order*, we decline to adopt the "weighted channel" approach suggested by Continental and Avenue TV. As we stated in Section III, *supra*, we believe that in many cases a reasonable measure of the costs of tangible plant would be a straight channel ratio. The weighted channel approach suggested by Continental and Avenue TV creates a bias towards the BST when, in fact, plant usage is most often directly attributable to the number of channels supported. Generally, incremental increases in plant investment are driven by the number of channels added, irrespective of subscribership to BST channels. The number of subscribers does not impact costs in most cable equipment categories. Accordingly, we believe that in most cases, a straight channel ratio would be a reasonable approach to the allocation of plant costs amongst service baskets.

124. We also reject Continental's suggestion that advertising revenues and home shopping services be assigned to the "other cable services" category. The allocation approach for cost of service showings reflected in FCC Form 1220 indicates that revenues received for advertising and home shopping on a regulated tier should be allocated to that tier, and used as an offset to providing service on that tier. We adopted this approach because advertising and home shopping shown on regulated channels employ regulated assets and, consequently, these revenues should be distributed as offsets to the regulated tier revenue requirements.

XI. ACCOUNTING REQUIREMENTS

A. Background

125. In the *Cost Order*, we stated that we would adopt a uniform system of

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[263] *Id.*

[264] *Id.*

accounts for those cable operators that elect cost of service regulation.[265] We believed that a uniform accounting system would ensure that operators accurately record their revenues, operating expenses, depreciation expenses, and capital investments. In addition, a uniform system of accounts presumably would simplify cost of service proceedings, since variations in operators' accounting practices would be minimized. Therefore, we proposed and sought comment on an accounting system we felt would be workable and reliable.[266]

126. We concluded that until a uniform system of accounts could be finalized, operators electing cost of service regulation should use an interim summary accounting system.[267] Under the interim system that we adopted, operators using FCC Form 1220 identify costs in 55 summary level accounts, and small operators using FCC Form 1225 identify costs in 32 summary level accounts. Operators are required to identify all amounts associated with each revenue and cost category at the franchise, system, regional and/or company level, depending on the organizational level at which the operator identified revenues and costs for accounting purposes as of April 3, 1993.[268] Local franchising authorities and the Commission may require operators to provide any additional financial data and explanations necessary to substantiate a cost of service filing and may order appropriate disallowances if an operator fails to provide a reasonable response.

B. Comments

127. Several cable operators argue that adopting a uniform system of accounts would be overly burdensome and costly for both the cable industry and the Commission. Comcast claims that it is not feasible for cable operators that are part of larger organizations to create new accounting systems for only those systems that opt for cost of service regulation.[269] According to Comcast, such operators would have to convert all of their systems to the new accounting system, which would be expensive, time-consuming, and wasteful.[270] Similarly, Avenue TV opposes a uniform accounting system because the expense of converting to such a system would effectively preclude some operators, especially small

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[265] *Cost Order*, 9 FCC Rcd at 4641. We decided, however, not to require operators that are regulated under the benchmark system to maintain their accounts in accordance with a uniform accounting system since the benchmark system is primarily concerned with an operators' prices, rather than costs. *Id.*

[266] *See id.* at 4714-58.

[267] *Id.* at 4643.

[268] *See* 47 C.F.R. § 76.924(c).

[269] Comcast Petition for Reconsideration at 22.

[270] *Id.*

operators, from electing cost of service regulation.[271] Falcon Cable TV ("Falcon") claims that a uniform system would necessitate hiring new professional staff and expanding the company's computer capacity.[272] According to Falcon, the heterogeneity of the cable industry would complicate the implementation of a uniform system, which would be an extremely involved and time-consuming process.[273] Time Warner argues that the many years it took the Commission to develop a workable accounting system for the telephone industry demonstrates the futility of trying to design a comparable system for cable companies within the time period that most cable systems will be subject to rate regulation.[274] Comcast is also skeptical that the Commission could devise a uniform system of accounts in time for it to be applied to most cost of service cases.[275]

128. Cable operators contend that adopting a uniform system of accounts would violate Congress' intent to simplify cable rate regulation as much as possible. Comcast argues that requiring cable operators to use an accounting system akin to the model designed specifically for common carriers would contravene the Congressional mandate that cable rate regulation not duplicate common carrier regulation.[276] Falcon avers that imposing a uniform accounting system would conflict with Congress' directive to minimize regulatory burdens on cable operators.[277] Falcon notes that Congress did not grant the Commission explicit authority to adopt a uniform system; to the contrary, Congress determined that cable companies should not be subject to regulation as common carriers.[278] Continental argues that the fact that the telephone industry is subject to a uniform system of accounts is not a sufficient reason for imposing one on the cable industry.[279]

129. In addition, Continental asserts that FCC Form 1220 already provides the Commission with the uniformity it is seeking, and thus the benefits to be gained by uniform accounting requirements are outweighed by the burden and expense involved in

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[271] Avenue Comments at 8.

[272] Falcon Comments at 7.

[273] *Id.* at 8-11.

[274] Time Warner Comments at 21.

[275] Comcast Petition for Reconsideration at 23.

[276] Comcast Reply Comments at 14.

[277] Falcon Comments at 5.

[278] *Id.* at 6.

[279] Continental Reply Comments at 16.

converting to a uniform system.[280] Comcast agrees that sufficient uniformity is achieved through the use of FCC Form 1220 and a uniform system of accounts would not increase the accuracy of cost of service filings.[281]

130. Bell Atlantic supports the Commission's decision to adopt a uniform accounting system and believes it should be applied to all regulated cable systems regardless of whether they submit cost of service or benchmark filings.[282] Bell Atlantic argues that the cable industry should be subject to standardized accounting rules that are comparable to those applicable to the telephone companies, especially in light of the impending convergence of the two industries.[283] Williamson also agrees with the Commission's proposal to establish a uniform accounting system because it is similar to the one currently applicable to the telephone industry.[284] In addition, GTE favors the adoption of a uniform system of accounts, which it states is a "typical and expected component of utility regulation."[285]

C. Discussion

131. We conclude that a uniform system of accounts would be unnecessarily burdensome for cable operators at this time. Our review of the cost of service filings has shown that FCC Forms 1220 and 1225 generally provide a sufficiently detailed basis for evaluating operators' rates. The additional detail provided by a uniform system of accounts would be of limited value since most of the filing defects we have discovered thus far are company-specific and would not have been prevented by a uniform accounting system. Our practice of issuing deficiency letters when questions arise has proved to be an adequate means of clarifying data. Therefore, we agree that investing the time required to develop a uniform system would be counter-productive to achieving our objective to process cases as expeditiously as possible. We are also persuaded that imposing a different accounting system on the relatively few systems filing cost of service justifications may create administrative inefficiencies for cable operators. Therefore, we will not adopt a uniform accounting system but will require operators electing cost of service regulation to follow the accounting standards required by FCC Forms 1220 and 1225, thus making permanent our interim accounting

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[280] Continental Comments at 64; Continental Reply Comments at 16.

[281] Comcast Reply Comments at 14.

[282] Bell Atlantic Reply Comments at 14-15.

[283] Bell Atlantic Reply Comments at 14-16; Bell Atlantic Opposition to Petitions for Reconsideration at 6.

[284] Williamson Comments at 3.

[285] GTE Comments at 11.

standards.[286]

XII. AFFILIATE TRANSACTIONS

A. Background

132. In the *Cost Order,* we promulgated rules for valuing transactions between cable operators and affiliated companies.[287] These rules were designed to prevent favorable self-dealing between affiliated companies in order to manipulate our rate rules. We defined an affiliated entity as one that shares a 5% or greater ownership interest with the cable system operator.[288] The interim rules require an affiliated transaction to be valued at the "prevailing company price," if the provider has sold the same kind of asset or services to a substantial number of third parties at a generally available price.[289] If the provider has not been engaged in similar transactions with a substantial number of third parties, the rules distinguish between the sale of an asset and the sale of a service.[290] If the transaction involves an asset, the cable operator is required to value the transaction at the higher of cost or fair market value when the cable operator is the seller and the lower of cost or fair market value when the cable operator is the purchaser.[291] If the transaction involves a service and no prevailing company price can be established, the cable operator is required to value the service at the service provider's cost.[292]

133. In the *Further Notice*, we sought comment on whether the interim rules should be adopted as our final rules, including: (1) requiring cable operators that do not meet the prevailing company price test to value the assets at the higher of cost or fair market value when the cable operator is the seller and the lower of cost or fair market value when the cable operator is the purchaser and (2) whether the current definition of affiliate should be retained.

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[286] Although we will not establish a uniform system of accounts at this time, we may revisit the issue in the future if events, such as convergence of the cable and telephone industries, create an environment where it would make sense to adopt a uniform system of accounts for cable companies.

[287] *Cost Order*, 9 FCC Rcd at 4658-68.

[288] *Id.* at 4667-68.

[289] *Id.* at 4665-66.

[290] *Id.* For the purposes of evaluating affiliate transactions, programming is considered an asset. *Id.* at 4666-67.

[291] *Id.* at 4665-66.

[292] *Id.* at 4666.

Other issues to be resolved include: (1) whether our final affiliate transaction rule should be included in the uniform system of accounts, should we adopt one for cable operators and (2) whether the cable services affiliate transaction rule should conform with the affiliate transaction rule being considered with regard to common carriers.[293] This final proposal would have prevented cable operators from valuing assets or services at the operators' prevailing company prices unless the providing affiliates sell more than 75% of their total output to nonaffiliates.

B. Comments

134. The most common issue addressed in the comments concerns the proposal that would prevent cable operators from valuing assets or services at the operators' prevailing company prices unless the providing affiliates sell more than 75% of their total output to nonaffiliates. The majority of the commenters oppose this amendment of the interim rules arguing that it is unnecessary in the context of the cable industry.[294] These commenters argue that while the affiliate transaction rules are necessary in the context of telephone regulation, that need arises as an outgrowth of the faulty incentives created by rate of return regulation of the telephone industry where there has been a long history of cross-subsidization.[295] According to these commenters, no such history of abusive affiliate transactions exists for the cable industry so there is no need for such rules.[296] The telephone companies argue that the current rules are appropriate for both the cable industry and the telephone industry, but in any case whatever rules are ultimately adopted for telephone companies should apply to cable as well.[297] Williamson supports the Commission's affiliate transaction proposals because they conform with the Commission's proposed rules for telephone companies.[298]

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[293] *Further Notice* 9 FCC Rcd at 4683-86.

[294] *See, e.g.*, Liberty Media Comments at 4-9; Time Warner Comments at 23-24; TCI Comments at 45-50; TBS Comments at 4-15; Rainbow Comments at 3-6; Discovery Communications Comments at 2-7; Jones Education Networks, Inc. Comments at 3-4; NCTA Reply Comments at 3-5.

[295] *Id.*

[296] *Id.*

[297] Bell Atlantic Comments at 10-11; BellSouth Comments at 4. GTE states that Congress has specifically found that cable operators frequently act to undermine the very programming distribution objective. GTE Reply Comments at 5. GTE states that it was for this reason that the Cable Act protects video programming vendors from anticompetitive actions of multichannel video programming distributors.

[298] Williamson Comments at 5.

135. Time Warner argues that the record does not justify any affiliate transaction rules, since the affiliation between programmers and cable operators in the cable industry has been driven purely by market forces.[299] According to Time Warner, while the affiliate transaction rules are an outgrowth of the faulty incentives created by rate of return regulation in the telephone industry where there has been a long history of cross-subsidization, rules covering transactions between cable operators and their affiliates are not warranted because no such history exists for the cable industry.[300]

136. Jones Education Networks, Inc. ("Jones") argues that we should provide a window for new services, *i.e.*, a period of looser regulation during which programmers will have an opportunity to market their new services to a substantial number of third parties.[301] Jones states that the Commission should adopt a presumption that, during this window, the price that is paid for programming by affiliated systems comports with the prevailing company price that has been established by the programmer where the programmer is marketing the service to nonaffiliated operators.[302] If at the end of two years the programmer has not reached a significant number of unaffiliated parties, Jones notes, then alternative costing tests would be applicable.[303] Even then, Jones states, the operator should have an opportunity to show that the programming is being priced at its estimated fair market value.[304] Absent such a showing, Jones recommends that the offset be based on the programmers' overall costs and not their net book costs.[305]

137. Bell Atlantic states that while there are strong arguments for less restrictive requirements than those contained in the *Further Notice*, the Commission correctly recognizes that whatever rules are ultimately adopted for telephone companies should apply to cable as well.[306]

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[299] Time Warner Comments at 23.

[300] *Id.* at 24-25.

[301] Jones Comments at 10.

[302] *Id.*

[303] *Id.*

[304] *Id.*

[305] *Id.*

[306] Bell Atlantic Comments at 10-11. *See also* BellSouth Comments at 4; Bell Atlantic Reply at 4-5; USTA Reply Comments at 3-5. USTA opposes the Commission's proposal to change the affiliate transaction rules. USTA suggests that it would be costly and extremely difficult to estimate the fair market value of services in affiliate transactions. Moreover,

C. Discussion

138. Once again we reject the arguments of those petitioners and commenters which assert that there is no need for an affiliate transaction rule in the context of cable rate regulation. These arguments rely on the assertion that there is no history of abusive affiliate transactions in the cable industry and thus no need for an affiliate transaction rule. These arguments fail simply because the history upon which they rely is a history absent rate regulation. In such an environment no incentive exists for abusive affiliate transactions. We need not wait for abuse before providing ratepayers with reasonable protection.

139. The affiliate transactions issue was previously addressed, in part, in the *Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking*.[307] There, we declined to amend the current rule to prevent cable operators from valuing assets or services at the operators' prevailing company prices unless the providing affiliates sell more than 75% of their total output to nonaffiliates.[308] We specifically reserved the discretion to monitor and revisit this issue should the current rule prove inadequate or unworkable.[309]

140. We reject the arguments made by Jones to permit a window for new services, *i.e.*, until they can market their services to a substantial number of third parties. In a competitive market, programmers would not be able to subsidize new services with higher rates for competitive services. Similarly, in a regulated industry, programmers cannot expect regulated ratepayers to subsidize new programming ventures.

141. Beyond the problem of determining the prevailing company price, we requested comment on an appropriate method of valuing an asset absent a prevailing company price. The interim rules require cable operators that do not meet the prevailing company price test to value assets at the higher of cost or fair market value when the cable operator is the seller and the lower of cost or fair market value when the cable operator is the purchaser. Ruling that cable operators are permitted to value services at the provider's cost is consistent with the current rules for telephone companies and there appears to be no reason to distinguish the two industries in this particular context. This is especially true in light of the more liberal definition of prevailing company price in the cable services regulatory scheme.

USTA states that by suggesting this fair market value requirement for cable companies, the Commission may have pre-judged the merits of the proposal for telephone companies.

[307] Sixth Order on Reconsideration, Fifth Report and Order, and Seventh Notice of Proposed Rulemaking, MM Docket No. 92-266, MM Docket No. 93-215, 10 FCC Rcd 1226 (1995).

[308] *Id.* at 1269-70.

[309] *Id.* at 1270.

142. The current definition of "affiliate" is consistent with the definition used elsewhere in the cable services regulatory scheme.[310] There appears to be no compelling reason to amend the definition and we decline to do so at this time.

143. Finally, we requested comment as to whether the interim affiliate transaction rules should be incorporated into a uniform system of accounts. Since we have found that no need exists at this time to adopt a uniform system of accounts, this point is moot.[311]

XIII. SOCIAL CONTRACTS

A. Background

144. In the *Cost Order*, we adopted an experimental program designed to give operators incentives to upgrade their systems and services. Specifically, we invited operators to propose upgrade incentive plans, also known as social contracts, with their subscribers, pursuant to which operators would be given substantial flexibility in setting rates for new regulated services, in exchange for which customers would be guaranteed that existing services, or their equivalent, would remain in place at stable and reasonable rates.[312] The operator also would commit to otherwise maintaining or improving the quality of its services.[313] The Commission would oversee implementation of the contract and would review the operator's compliance before the end of the contract term.[314] We proposed to review such plans in the fifth year of operation.[315]

145. In general, our review of the rates of an operator that had implemented a valid social contract would be limited to determining whether the operator continued to provide existing services at rates no higher, and quality no lower, than obtained prior to the implementation of the plan.[316] Rates for the additional regulated services added pursuant to

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[310] In the *Rate Order* we adopted a 5% threshold for defining an affiliate for purposes of determining the extent to which cable operators could pass programming charges through to ratepayers. 8 FCC Rcd at 5788, n. 601.

[311] *See infra* at ¶ 121.

[312] *Cost Order*, 9 FCC Rcd at 4678.

[313] *Id.*

[314] *Id.*

[315] *Id.* at 4680.

[316] *Id.* at 4679.

the contract would not be subject to review unless shown to be outside a wide range of reasonableness.[317]

146. In the *Further Notice*, we proposed refinements to the social contract approach as described in the *Cost Order*. For example, we suggested that operators would have to receive approval for the contract in advance of any upgrade if it sought to claim the full flexibility offered by such plans.[318] We proposed permitting local franchising authorities to establish certain guidelines with respect to the basic tier that the operator would have to observe in order to qualify for a social contract.[319] We also sought comment on ways to ensure that existing services did not suffer, in terms of price and quality, as the operator established its new services under the terms of the contract.[320]

B. Comments

147. Cable commenters generally urge that we restrict the role of franchising authorities in the development and oversight of social contracts.[321] The National Association of Telecommunications Officers and Advisors ("NATOA") urges the Commission to ensure that cable operators are not able to increase the rates, or decrease the quality, of regulated services under the guise of implementing a social contract.[322] Continental contends that NATOA's comments indicate the need to clarify Commission policy with respect to such contracts.[323] Several commenters concur in this conclusion.[324] Cable Telecommunications Association ("CATA") seeks clarification regarding the level of upgrade that the operator must propose in order to qualify for the social contract, suggesting that such plans should be available "for any level of upgrade."[325] CATA also argues that our intention that an operator's rates be subject to review after some period of time will discourage operators from

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[317] *Id.*

[318] *Id.* at 4690.

[319] *Id.*

[320] *Id.* at 4690-91.

[321] Time Warner Comments at 37; NCTA Reply Comments at 19.

[322] NATOA Comments at 2-3.

[323] Continental Reply Comments at 19.

[324] CATA Comments at 5-6; Falcon Reply Comments at 2.

[325] CATA Comments at 6.

pursuing social contracts.[326]

148. Commenters emphasize the need to maintain flexibility given the varying needs and circumstances of individual cable operators,[327] although Continental urges us to articulate any particular priorities that will guide Commission review of proposed contracts.[328] Falcon suggests that we prescribe certain requirements that generally must be included in every upgrade plan proposed in a social contract, such as minimum bandwidth capacity, fiber-to-the-node, and free wiring of public schools.[329] Falcon also suggests the adoption of standardized cost information concerning the cost of constructing a mile of plant meeting the minimum requirements of the contract.[330] Under this approach, operators would have to report their actual costs, but those costs would be accepted on their face if they did not exceed the standardized costs developed by the Commission. Falcon further asks for retroactive application of the social contract approach such that operators could use such plans to recover the costs of upgrades commenced or completed in 1992, to the extent such costs were not reflected in prior rate increases.[331]

149. With respect to prospective upgrades that are the subject of social contracts, Falcon recommends that the operator be able to start recovering the cost of an upgrade upon completion of construction and certification to the Commission of the amount of those costs and that the upgrade conforms with the approved plan.[332] Costs would then be amortized over seven to eight years, a figure which Falcon claims is based on the physical life of plant, obsolescence, and generally accepted accounting principles relating to depreciation.[333] Costs would be allocated among regulated and unregulated services based on the percentage of bandwidth devoted to each type of service as a result of the upgrade, under Falcon's proposal.[334] Falcon contends that the limitation on when an operator can adjust equipment rates via Form 1205 is inappropriate in the context of a social contract, because the upgrade

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[326] *Id.*

[327] Continental Reply Comments at 19; Time Warner Comments at 35.

[328] Continental Reply Comments at 20.

[329] Falcon Reply Comments at 3-4.

[330] *Id.* at 4.

[331] *Id.* at 3.

[332] *Id.* at 5.

[333] *Id.*

[334] *Id.*

schedule might not be synchronized with the window in which the operator has the opportunity to adjust such rates.[335]

150. Continental contends that operators will have no incentive to commit to upgrades within the parameters of a social contract unless they are given the flexibility to raise rates for regulated services to the extent necessary to fund such upgrades.[336] Continental encourages the use of a single social contract and upgrade plan for all of the systems of an MSO.[337]

151. Bell Atlantic supports the idea of social contracts, contending that they "not only will spur innovation by creating an incentive to develop and introduce new services, but will also promote infrastructure development."[338]

C. Discussion

152. Since the close of the comment period in this proceeding, the Commission has pursued the social contract experiment in several contexts. In one case, the Cable Services Bureau granted a joint petition by a cable operator and its franchising authority seeking approval of an upgrade incentive plan. Since then, the Commission has entered into social contracts with two large MSOs. This experience convinces us to adopt the social contract approach as part of our final rules. In addition, the terms of these specific arrangements should provide the guidance that commenters found lacking in our earlier discussions regarding social contracts.

153. For example, early this year the Cable Services Bureau approved a joint petition filed by Horry County, South Carolina and Horry Telephone Cooperative, Inc., a cable operator serving just under 15,000 subscribers in that county.[339] Under the plan, the operator agreed to invest more than $8 million in a system upgrade designed to increase channel capacity and signal quality. The upgrade consisted of the installation of about 200 miles of fiber optics throughout its cable system so as to upgrade the system bandwidth from 220 MHz to 550 MHz, increasing the number of available program services from 22 to 47. In response to subscriber demand, the upgraded system would include a BST with fewer channels than on the old system at a substantially lower price. The plan also dictated rates for

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[335] *Id.* at 7.

[336] Continental Reply Comments at 21-26.

[337] *Id.* at 22.

[338] Bell Atlantic Comments at 12.

[339] In the Matter of Horry Telephone Cooperative, Inc. and Horry County, South Carolina, Memorandum Opinion and Order, DA 95-68, 10 FCC Rcd 2110 (1995).

the new, expanded CPST and froze subscribers' existing rates until they were switched to the upgraded system. The four year agreement also addressed rate increases to be taken after the completion of the upgrade and equipment rates.

154. On August 3, 1995, the Commission adopted a social contract with Continental.[340] The contract requires Continental to invest at least $1.35 billion to rebuild and upgrade all of its domestic systems between 1995 and 2000 and to make refunds to subscribers in settlement of pending BST and CPST cases. Continental will reduce BST rates by 15% to 20% and offset this reduction in a revenue neutral manner via adjustments to CPST tiers. Local franchising authorities will have the authority to review the restructured BST rates to ensure that they comply with the terms of the social contract and the Commission's rules. Local authorities also could opt out of the social contract with respect to certain terms affecting the BST. The social contract also governs the creation and rate regulation of migrated product tiers ("MPTs") and new product tiers ("NPTs").

155. We have entered into a similar social contract with Time Warner.[341] This contract requires Time Warner to invest $4 billion in system rebuilds and upgrades between 1995 and 2000, including deployment of fiber optics technology, increased channel capacity and improved system reliability and signal quality. The Time Warner contract also calls for over $4 million in refunds to subscribers, the creation of a low-cost BST, free service connections to public schools and permits the creation of MPTs. This contract resolves 946 pending CPST cases and allows local franchising authorities to resolve pending BST cases.

156. Our experience with the plans and contracts described above supports the view of commenters who contend that the Commission should remain flexible with respect to the scope and terms of such arrangements. The Horry County plan involves the operator of a single system who serves fewer than 15,000 subscribers and who will be making an upgrade investment of about $8 million. By contrast, each of the two other agreements described above involve MSOs that serve millions of subscribers and that have agreed to invest billions of dollars in the upgrade. Likewise, while the two MSO agreements involve provisions for resolving existing rate cases, we have not limited social contracts to operators who are the subject of such cases. Therefore, while the social contracts that have been adopted or are pending establish some precedent in this area, we will remain flexible and invite operators to propose upgrade plans appropriate for their circumstances. For this reason, we will not adopt specific conditions that must be a part of every social contract, such as those proposed by Falcon.

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[340] In the Matter of Social Contract for Continental Cablevision, Inc., Order, FCC 95-335 (rel. Aug. 3, 1995).

[341] In the Matter of Social Contract for Time Warner Cable, FCC 95-478 (rel. Nov. 30, 1995).

157. We also decline to adopt specific restrictions on the role of franchising authorities with respect to social contracts. We agree with NATOA regarding the need to ensure that existing regulated service is maintained or improved in terms of price and quality, and local franchising authorities may play an important role in this regard. A comparison of the Continental and Time Warner social contracts demonstrates that the appropriate role of local franchising authorities will vary. Moreover, we expect and welcome the submission of plans that the operator has first to the franchising authority before even coming to us, as in the case of Horry County. In any event, we see no reason, or even avenue, for establishing general rules governing the role of franchising authorities.

158. We appreciate CATA's concern that a general threat of rate review at some point in the future could inhibit some operators from proposing social contracts. By the same token, however, we do not believe that a cable operator's compliance with the terms of a social contract, by itself, relieves the Commission of its continuing obligation to regulate the BST and CPSTs of any cable system that is subject to regulation under the 1992 Cable Act.[342] The solution lies in specifying the terms of such review in advance, as part of the social contract. The plans and agreements that we have adopted to date provide an appropriate level of certainty for the operators, while allowing the Commission and local franchising authorities to protect subscribers from unreasonable rates for regulated services. Future agreements will contain similar provisions.

159. Establishing a standardized schedule of costs for installing a mile of plant, as Falcon suggests, would introduce an unnecessary layer of regulation. Adoption of such a proposal could require us to make a number of distinctions, such as between underground and overhead plant, and to make allowances for variations in the cost of labor and materials in different portions of the country. Moreover, any prescribed cost schedule would have to be updated periodically to take account of inflation and other variables affecting costs. We are not persuaded that the availability of such schedules would simplify matters for a sufficient number of operators to justify their adoption.

160. We will adopt, however, our proposal to require operators to seek advance approval of upgrades proposed for social contract treatment. This condition should not burden operators since a prudent operator presumably would verify its eligibility for the incentive plan before committing to the upgrade, as opposed to waiting until after completion of the upgrade to determine the regulatory impact of its investment. Moreover, requiring pre-approval will provide certainty to subscribers that the operator will be maintaining or improving current rates and quality with respect to existing services. In addition, we believe that retroactive application of the social contract approach is unwise. The purpose of this approach is to give operators incentives to commit to upgrades that they might not otherwise undertake, rather than to provide additional rewards for upgrades that the operator deemed necessary independent of our rules. As to such upgrades, our existing rules should permit

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[342] Communications Act, § 623(a)(2).

operators to recover their costs in any event.

XIV. HARDSHIP RATE RELIEF

A. Background

161. In the *Cost Order*, the Commission recognized that, in certain extraordinary cases, rate regulation under either the benchmark or cost of service mechanisms would threaten an operator's financial health or ability to provide service.[343] In such situations, an operator may obtain special rate relief by demonstrating that rate regulation using either of the two standard rate-setting options would cause such financial harm that the operator would be unable to attract capital or maintain credit necessary to operate, despite prudent and efficient management.[344] The operator must show that the requested rate relief would not be unreasonable or exploitative of customers.[345] In other words, rates cannot be excessive compared to competitive rates of similarly situated systems.[346] Hardship showings must be made for the MSO level, or the highest level of the operator's cable system organization.[347] Operators that submit an adequate initial showing of facts which, if proved, might warrant special relief, are subsequently given the opportunity to prove the facts alleged in the showing.[348]

B. Comments

162. Cablevision Industries Corporation ("CVI") argues that the hardship rule delays adequate relief because it requires that the standard rate-setting approaches be exhausted first.[349] CVI complains that further delay is caused by requiring an initial showing as part of a two-step process.[350] CVI claims that such delays in the process could be critical

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[343] *Cost Order*, 9 FCC Rcd at 4676.

[344] *Id.* at 4677.

[345] *Id.*

[346] *Id.*

[347] *Id.*

[348] *Id.*

[349] CVI Petition for Reconsideration at 5.

[350] *Id.* at 5-6.

for an operator that is suffering financial difficulties sufficient to warrant hardship relief.[351] Since hardship relief is a safety net to prevent confiscatory rate regulation, CVI notes that undue burdens on its use have Fifth Amendment repercussions.[352] CVI believes a one-step hardship process without the exhaustion requirement would cure this constitutional deficiency.[353]

163. CVI argues that the hardship rule suffers other defects as well. Hardship showings based on total revenues from cable operations at the highest organizational level sweep unregulated revenues into the assessment of hardship, which CVI claims is outside the Commission's jurisdictional authority.[354] In addition, CVI asserts that operators should be able to make hardship showings at whatever level of the organization is most appropriate given the specific circumstances of the company.[355] Not only does the 1992 Cable Act contemplate rate regulation at the franchise or system level, but hardship showings at the MSO-wide level will force operators to divert resources from healthy systems to unhealthy ones, jeopardizing service quality of the otherwise healthy systems.[356] Finally, CVI argues that competitive rates prevailing at similarly situated systems should not be a regulatory ceiling on rates sought in a hardship application.[357] CVI contends that if hardship rates cannot exceed competitive rates, the hardship process is rendered meaningless because operators seeking special relief have already determined that they cannot survive by charging rates permitted under the Commission's standard rate-setting approaches.[358]

C. Discussion

164. It appears that CVI misunderstands the requirement that an operator applying for hardship relief must first demonstrate the insufficiency of rates permitted by the benchmark or cost of service schemes. Contrary to CVI's apparent misperception, an operator applying for hardship relief is not expected to "proceed through the regular regulatory

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[351] *Id.* at 6.

[352] *Id.* at 3-4.

[353] *Id.* at 7-8.

[354] *Id.* at 8-9.

[355] *Id.* at 9-10.

[356] *Id.* at 10.

[357] *Id.* at 11.

[358] *Id.*

processes"[359] in any formal manner by first filing benchmark or cost of service forms. It is true that the operator, in order to demonstrate eligibility, must determine what its rates would be using standard rate-setting methods, but such an exercise is necessary in order for the operator to conclude that the resulting rates would have severe financial consequences. We do agree with CVI, however, that the process could be shortened by eliminating the requirement of an initial showing. We will therefore allow operators to combine the requirements of the initial factual showing and the subsequent evidentiary showing into one pleading.

165. We disagree with CVI that we are not authorized to consider an operator's unregulated revenues when determining eligibility for hardship relief. An evaluation of an operator's financial health that is based on only a portion of the operator's revenues would be incomplete and inaccurate. Similarly, it is appropriate to consider a hardship pleading in light of an operator's revenues measured at the highest level of the operator's organization. Hardship relief is an extraordinary relief measure reserved for operators whose overall financial health would be seriously threatened under the standard rate regulation mechanisms. It is not designed to bail out struggling cable systems that are owned and operated by prosperous MSOs. Lastly, the requirement that rates cannot be excessive compared to competitive rates of similarly situated systems does not mean that rates cannot exceed competitive rates. Rather, we expect operators to show that their rates would not exceed competitive rates to a degree that would be unreasonable.

XV. PROCEDURAL ISSUES

A. Background

166. In the *Cost Order*, we sought to adopt procedural requirements and options that would minimize regulatory burdens for operators and regulators, while ensuring the accuracy of the rate-setting process. We provided generally that after setting initial regulated rates under either the benchmark or cost of service approach, cable operators may not use the cost of service rules to set a new rate for two years.[360] This limitation provides for rate stability and minimizes regulatory burdens, while allowing operators the ability to make a reasonable return. The two-year period is measured from the effective date of the rates set in a franchising authority or Commission order.[361] Operators who believe it necessary to file a cost of service showing before the end of two years may seek a waiver in accordance with our general rules governing such relief.[362]

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[359] *Id.* at 5.

[360] *Cost Order*, 9 FCC Rcd at 4541.

[361] *Id.* at 4541, n. 42.

[362] *Id.*

167. Other than the two-year limitation, we placed no restrictions on a system's eligibility to make a cost of service showing.[363] Moreover, we declined to give franchising authorities the option to initiate cost of service proceedings.[364]

B. Comments

168. Cable operators suggest a number of adjustments to the procedures by which cost of service filings are reviewed. Some argue that operators should be entitled to notice from regulators of specific perceived defects in their cost of service filings and be given an opportunity to correct those defects.[365] For cost of service cases, operators seek to extend the 30 day period following the initiation of regulation in which they are required to make their filing.[366] Operators also seek the right to obtain and respond to consultants' reports or other analyses upon which a regulator proposes to rely in setting the cable operator's rates.[367]

169. Continental urges the Commission to clarify that regulators may approve maximum reasonable rates below which a cable operator would be granted pricing flexibility without being subject to a new rate review each time a price is changed.[368] For example, Continental maintains that a cable operator whose rates have not increased more than inflation since the beginning of deregulation under the 1984 Cable Act should not be put to the burden of a full cost of service defense in the absence of some specific evidence -- not merely a complaint -- that its current rates are too high.[369] Continental also recommends that the Commission clarify that the two year limit on filing cost of service cases does not apply when the operator has been called upon to justify existing rates.[370]

170. Continental also urges the Commission to clarify the level of detail

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[363] *Id.* at 4543.

[364] *Id.* at 4543-44.

[365] Continental Comments at 73-74; Avenue TV Comments at 12-13.

[366] Continental Comments at 76; Avenue TV Comments at 12-13.

[367] Continental Comments at 74-75; Avenue TV Comments at 12-13.

[368] Continental Comments at 66-69.

[369] *Id.*

[370] *Id.* at 77-79.

required of operators with respect to various data called for by Form 1220.[371] Operators should be permitted, or even required, to file electronically, according to Continental.[372] Continental asks us to clarify that Commission staff and an operator that is the subject of a pending rate case are free to make inquiries of each other concerning the matter.[373] Continental also suggests that Commission staff meet with the operator before issuing a decision, if necessary to ensure the completeness of the record.[374] Continental asks that we not deem cost of service cases as restricted proceedings for purposes of our ex parte rules, such that any party to the proceeding may submit unsolicited filings and otherwise initiate contact with the Commission, subject only to the requirement that all parties be served with notice of the contact.[375]

171. Finally, Continental argues that when making judgments in individual cost of service cases, franchising authorities and the Commission should exercise discretion in the cable operator's favor.[376] First, Continental contends that the Commission's relatively recent entry into the area of cable rate regulation suggests that it should be reluctant to question the discretionary judgment of cable operators. Second, rate regulation burdens cable operators in the exercise of their First Amendment rights and therefore the Commission must ensure that such regulation is "narrowly tailored to implement a significant governmental purpose," according to Continental.[377] In particular, Continental contends, the First Amendment requires that operators be permitted to charge the highest reasonable rate available since mandating any lower rate would impermissibly burden protected speech.[378]

172. Time Warner states that the Commission should allow cable companies to readily switch between cost of service and benchmark elections.[379] Time Warner claims that such flexibility is necessary in order to permit the most efficient pricing by cable

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[371] Continental Reply Comments at 27.

[372] *Id.* at 28-29.

[373] *Id.* at 29.

[374] *Id.* at 31.

[375] *Id.* at 33.

[376] Continental Comments at 70-73.

[377] *Id.* at 71, citing *Riley v. National Federation of the Blind*, 487 U.S. 781, 790 (1988).

[378] *See also* Public Interest Petitioners Petition for Expedited Reconsideration at 13-14.

[379] Time Warner Comments at 15-16.

companies.[380] TCI argues that the cost of service rules are exceptionally burdensome and asks the Commission to search for ways to lessen the burden of such showings, for the benefit of operators, regulators, and subscribers.[381]

173. Avenue TV also supports regulations that ease the burden on operators who may be called upon to justify rates through a cost of service showing.[382] Avenue TV proposes that any operator who has made such a showing and has not made any subsequent rate increase not be required to make any additional showings as a result of a complaint.[383] In the alternative, Avenue TV proposes that any cost of service filing in response to a complaint should relieve the cable provider of the obligation to file further cost of service filings in response to future complaints for two years.[384] On the other hand, Avenue TV believes that if an operator deems it necessary, it should be permitted to make a cost of service showing within two years of initially setting its rates.[385]

174. Avenue TV argues that smaller cable systems are substantially different from both larger cable systems and telephone companies.[386] Avenue TV maintains that these differences create different difficulties for small cable providers and warrant a different regulatory scheme.[387]

C. Discussion

175. We believe the current procedures generally strike the appropriate balance between minimizing regulatory burdens and achieving rates that are both fair to the operator and reasonable to subscribers. Most of the changes urged by commenters would disrupt this balance either by complicating and delaying the manner in which rates are set, or by compromising our efforts to protect consumers from unreasonable rates.

176. In particular, we will not require franchising authorities to produce

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[380] *Id.*

[381] TCI Reply Comments at 11-12.

[382] Avenue TV Reply at 11.

[383] *Id.*

[384] *Id.*

[385] *Id.*

[386] *Id.* at 2.

[387] *Id.*

reports or analyses on which they rely in making their decisions. When an operator has made a cost of service showing and has submitted any additional data that the franchising authority requests, the franchising authority should then be in a position to determine the reasonableness of the rate that the operator has sought to justify.[388] Moreover, sufficient justification for a franchising authority's decision should be provided in its written order. We see no reason to add to the administrative process by prohibiting the issuance of a decision until the franchising authority has shared its reasoning and analyses with the operator and given the operator an opportunity for rebuttal, particularly given our obligation to minimize regulatory burdens.[389]

177. Moreover, we have imposed upon the operator the burden of proving the reasonableness of its rates.[390] We believe its position should stand or fall on the merits of the filing it has chosen to make. Forcing franchising authorities to turn over their analyses and reports essentially would permit operators to be less than exact when making their initial showing. We decline to adopt a procedure that might encourage inaccurate reporting and that would inevitably slow the ratemaking process. Of course, this does not preclude an operator from challenging a rate decision and its underlying analysis, since the operator can appeal to the Commission from a decision of a local franchising authority.[391]

178. There may be situations in which some dialogue between the operator and the franchising authority, including the sharing of data and analyses, may be useful in resolving differences and avoiding an appeal. Franchising authorities are free to pursue such a course when they deem it appropriate and we encourage them to do so. However, we believe that the franchising authority is in the best position to determine whether such a resolution is realistic in any given case. Therefore, we will not mandate the production of data by franchising authorities, but will leave that decision to the discretion of the franchising authority.[392]

179. Contrary to Continental's suggestion, we do not believe that serious

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[388] By requesting authority to regulate rates, a franchising authority certifies that it can and will regulate rates in accordance with our rules. Communications Act, § 623(a)(3).

[389] Communications Act, § 623(b)(2)(A).

[390] 47 C.F.R. § 76.937(a).

[391] 47 C.F.R. § 76.944.

[392] The Cable Services Bureau exercises analogous discretion when reviewing cost of service filings submitted directly to it, such as in response to a CPST complaint. For the reasons stated above with respect to local franchising authorities, we will not require that operators be notified of errors or deficiencies in their filings to the Bureau as a matter of course.

First Amendment concerns are raised by our cost of service rules, including the associated presumptions and the imposition upon operators of the burden of establishing the reasonableness of their cost of service showings. Our rate rules are subject to an intermediate standard of review under the First Amendment, and not strict scrutiny as Continental contends.[393] Therefore, the government's interest in promulgating the rules "must be important or substantial and the means chosen to promote that interest must not substantially burden more speech that necessary to achieve the government's aims . . . ."[394] The importance of the government's interest in regulating cable rates has been established.[395] Thus, the remaining issue is whether the cost of service rules "substantially burden more speech than necessary,"[396] or, to put it differently, whether the government's interest "would be achieved less effectively absent the regulation."[397]

180. We have no doubt that the cost of service rules survive this test. First, the rules apply only when, and for so long as, there is an absence of effective competition.[398] Second, in adopting the individual provisions of the rules, we have explained why our restrictions and presumptions are necessary to ensure the reasonableness of rates. In other words, we believe that the interests underlying the 1992 Cable Act "would be achieved less effectively" were we to recast the rules in the manner suggested by Continental. More specifically, we reject the contention of Continental that we must permit operators to establish rates "at the very top of the zone of reasonableness,"[399] since Continental bases that conclusion on the incorrect premise that our rules are subject to strict scrutiny. We believe our rules allow for rates well within the zone of reasonableness and therefore do not substantially burden more speech than necessary. We therefore reject Continental's argument that we must adopt rules that will set rates at the top of the zone of reasonableness in order to avoid unconstitutionally impinging on operators' First Amendment rights. Finally, despite Continental's claims to the contrary, we believe that requiring operators to rebut the presumed

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[393] *Time Warner*, 56 F.3d at 184. In *Time Warner*, the court specifically rejected the argument, made by Continental here, that the Supreme Court's decision in *Riley* mandates the application of strict scrutiny to cable rate regulation: "The analogy of this case to *Riley* fails at several critical junctures." *Id.* at 182.

[394] *Id.*, citing *Turner Broadcasting Sys., Inc. v. FCC*, 114 S.Ct. 2445, 2469 (1994).

[395] *Time Warner*, 56 F.3d at 184.

[396] *Id.*, citing *Turner*, 114 S.Ct.at 2469.

[397] *Time Warner*, 56 F.3d at 184, citing *United States v. Albertini*, 472 U.S. 675, 689 (1985).

[398] *See Time Warner*, 56 F.3d at 185-86.

[399] Continental Comments at 71.

applicability of our uniform rules on a case-by-case basis is a necessity if the goals of the 1992 Cable Act are to be achieved.[400] The alternative would be tantamount to allowing individual operators to dictate the presumed parameters of their cost of service showings, which would be "unworkable in light of administrative burdens such a scheme would entail."[401]

181. The issue of deficient filings by cable operators was addressed in the context of benchmark showings in a previous order.[402] In that order, we concluded that when a cable operator files a facially incomplete form, the franchising authority or the Commission may order the operator to file the supplemental information necessary to determine the reasonableness of the operator's rates.[403] While the franchising authority is waiting to receive the additional information, the deadlines applicable to its authority to rule on the rates are tolled.[404] The operator must be given a reasonable time in which to supply the requested data.[405] An operator that fails to meet the deadline can be deemed in default and be subject to sanctions.[406] We adopt the same guidelines with respect to incomplete cost of service showings.[407]

182. We decline to adopt the alternative rate-setting methods proposed by Continental, such as mandating that operators be permitted to set rates at the highest reasonable rates permitted by traditional cost of service principles or allowing greater pricing flexibility to operators that have had no rate changes since 1984. The cost of service rules establish a uniform procedure that enables cable operators to cover their operating expenses and to make a reasonable return on their investment, while protecting consumers from

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[400] *See Rate Order*, 8 FCC Rcd at 5798.

[401] *Time Warner*, 56 F.3d at 186.

[402] Third Order on Reconsideration in MM Docket Nos. 92-262 & 92-266 ("*Third Reconsideration Order*"), FCC 94-40, para. 86-92 (rel. March 30, 1994).

[403] *Id.* at para. 88.

[404] *Id.* at para. 88.

[405] *Id.* at para. 90.

[406] *Id.*

[407] We have drawn a distinction between an incomplete filing and a filing that is complete and submitted in good faith but as to which the regulating authority reasonably decides it needs additional information or clarification. *Third Order on Reconsideration* at para. 89. In the latter case, a request for more data will not automatically toll the franchising authority's deadlines. *Id.*

unreasonable rates. While we could permit operators to attempt to show that these same goals can be achieved by a variety of other methods, possibly including those proposed by Continental, we believe that confusion and lack of uniformity would outweigh any benefits that might result.

183. With respect to timing issues, we will maintain the requirement that the operator justify its rates within 30 days of receiving notice from the franchising authority. There is no evidence that operators are unable to comply with this deadline. Moreover, extending the deadline would simply slow the ratemaking process and postpone the implementation of the reasonable rates to which subscribers are entitled. Likewise, we do not believe operators should be permitted to make filings, or switch between the benchmark and cost of service methodologies, more often than our current rule permits. Given the ability of operators to adjust rates pursuant to the price cap mechanism, we cannot envision that a prudent operator would need to re-establish rates more often than is currently permitted. More frequent filings will only confuse subscribers and increase the burden on regulators.

184. However, we agree with commenters who cite the inefficiency of requiring a cable operator that has made one cost of service showing in response to a CPST complaint to make a separate showing every time an additional complaint is filed. Since the maximum permitted rates generated by an initial cost of service showing often are based on data from the most recent fiscal year, a subsequent showing within the next 12 months could be based on the same test year data and would generate the same permitted rate, exclusive of any adjustments made under our price cap requirements or the going forward rules. While a subsequent cost of service showing in the second year following rate regulation might generate lower rates, it might also generate higher rates. Either way, in most cases the difference would likely be minimal, particularly in comparison to the effort that operators and the Commission must expend to go through the rate review process. Any possible advantage of requiring such repetitive filings would be outweighed by the associated administrative costs. Moreover, we note that except in hardship cases, operators are prohibited from making a cost of service showing more than once every two years.[408] It seems unfair to subject operators to the threat of having to submit multiple cost of service filings within that two year period in response to complaints, while we prohibit operators from using the cost of service rules to adjust rates upward during that period. Accordingly, regulatory approval of a rate generated by a cost of service showing will be dispositive of all complaints filed with respect to that rate for the two year period beginning when the rate is instituted. Of course, this does not exempt the operator from having to justify any rate increase taken during the two year period upon the filing of a valid complaint concerning that increase.

185. As for smaller cable systems and operators, in the *Sixth Report and Order and Eleventh Order on Reconsideration* we adopted a streamlined cost of service approach for small systems owned by small cable companies. We believe this approach

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[408] 47 C.F.R. § 76.923(k).

adequately responds to the comments raised in this proceeding with respect to such entities.

XVI. OTHER MATTERS

186. There are five remaining issues that were raised in the *Cost Order* and/or the *Further Notice* which, for various reasons, we can dispose of with relatively little discussion. First, the *Further Notice* proposed adoption of a productivity offset.[409] The purpose of such an offset is to take account of efficiency gains enjoyed by cable operators that reduce the impact of inflation. To the extent cable operators enjoy such gains, the productivity offset would limit the ability of operators to adjust rates to reflect inflation. We resolved this issue in a previous order by declining to adopt a productivity offset.[410] We will address a pending petition for reconsideration of that order[411] in the near future.

187. Second, in the *Cost Order* we adopted an abbreviated cost of service procedure for use by independent small systems and small systems owned by small MSOs, as those terms were then defined.[412] As with all other aspects of the interim cost rules, we proposed to adopt this treatment of small systems as part of our final cost rules.[413] In a subsequent order, we redefined a small system as one serving 15,000 or fewer subscribers,[414] created a new class of operator, known as the small cable company, consisting of operators that serve 400,000 or fewer subscribers over all of their systems,[415] and established a new rate-setting scheme, known as the small system cost of service methodology, that gives small systems owned by small cable companies greater flexibility to establish rates in accordance with their particular needs and hardships via a simplified cost of service showing.[416] With the adoption of the *Sixth Report and Order and Eleventh Order on Reconsideration*, we have established a comprehensive scheme of rate regulation for small systems, including the new small system cost of service methodology, thus resolving all of the issues raised in this

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[409] *Further Notice*, 9 FCC Rcd at 4686-89.

[410] Memorandum Opinion and Order, MM Docket No. 93-215, FCC 94-226, 9 FCC Rcd 5760 (1994).

[411] Petition for Reconsideration of Bell Atlantic in MM Docket No. 93-215 (filed Nov. 14, 1994).

[412] *Cost Order*, 9 FCC Rcd at 4671.

[413] *Further Notice*, 9 FCC Rcd at 4681.

[414] *Sixth Report and Order and Eleventh Order on Reconsideration*, 10 FCC Rcd at 7406.

[415] *Id.*

[416] *Id.* at 7418-28.